1940

Audit of savings and loan associations by independent certified public accountants (1940); Audit and accounting guide:

American Institute of Accountants

AUDIT OF
SAVINGS AND LOAN ASSOCIATIONS
BY
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

A Bulletin Prepared and Published by the
AMERICAN INSTITUTE OF ACCOUNTANTS
JULY 1940

AUDIT OF SAVINGS AND LOAN ASSOCIATIONS

BY

INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Prepared and Published by the

AMERICAN INSTITUTE OF ACCOUNTANTS

JULY, 1940

Additional Copies of this Bulletin
May be obtained from the

AMERICAN INSTITUTE OF ACCOUNTANTS
13 East 41st Street, New York
at
25 CENTS PER COPY

CONTENTS

PREFACE

The program for the independent audit of savings-and-loan associations prepared by the American Institute of Accountants and contained in this pamphlet was considered and reviewed by duly authorized representatives of the accounting division of the United States Savings and Loan League, of the supervisors' division of the United States Savings and Loan League, and of the examining division of the Federal Home Loan Bank Board at a conference held in Chicago, Illinois, on January 30 and 31, 1940.

At that conference, this program was unanimously approved as providing a proper and adequate procedure for the independent audit of savings-and-loan associations and, as such, acceptable as meeting the requirements and needs of the investing public, the management of such institutions, and supervisory authorities.

AUDIT OF SAVINGS AND LOAN ASSOCIATIONS BY INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

SECTION 1

General

The program of activities issued by the American Institute of Accountants describes the duties of the special committee on savings-and-loan accounts as follows:

"Continue coöperation with Federal Home Loan Bank Board in an effort to devise program of independent audit of savings-and-loan associations insured by the Federal Savings and Loan Insurance Corporation, and recommend forms of financial statements and auditors' certificates which will satisfy requirements of the Board and eliminate necessity for audits of associations by examiners employed by the Board. Coöperate to whatever extent may be possible with the American Savings and Loan Institute."

In accordance with this program, the special committee has devised the following procedure for the audit of savings-and-loan associations. In considering what follows, the reader should bear in mind that the accountant must exercise discretion while conducting such audits; procedures must be varied to meet varying conditions due to the size and type of association and the requirements of state or federal authorities.

It is believed that compliance with the program outlined in this pamphlet will enable the accountant to render a report to savings-and-loan-association clients which will be acceptable to the association, to state authorities, and to the Federal Home Loan Bank Board. It is to be hoped that it will make possible more complete understanding between certified public accountants and supervisory authorities.

SECTION 2

Recent Developments

Since the organization of the first savings-and-loan association in this country over one hundred years ago, there have been many changes in financial procedure and management methods. Just as standardization in financial procedure has been impracticable, if not impossible, so it was likewise impracticable to attempt to standardize the accounting methods of savings-and-loan associations until the educational work of the United States Savings and Loan League and the American Savings and Loan Institute had made an impression on those interested.

The federal-home-loan-bank act and the creation of the Federal Home Loan Bank Board gave an immediate stimulus to thought on this subject. Each of the three above-mentioned groups has been publishing information on accounting problems, so that today there is available to every association throughout the country some very creditable material designed for its guidance in proper accounting.

The Federal Home Loan Bank Board has been very helpful by issuing periodical bulletins on the subject of accounting, and has developed an excellent examination procedure to aid it in its supervision of member associations. Foremost among the publications on the subject of accounting is the *Standard Accounting Manual for Savings and Loan Associations*, prepared by the American Savings and Loan Institute. The good effect of this manual has been supplemented by a course in accounting, conducted under the auspices of the same organization, in the larger cities of the nation. In addition, there are some very helpful articles on savings-and-loan accounting in the periodicals published by the several Federal Home Loan Banks, by the United States Savings and Loan League, and by the several state savings-and-loan leagues.

The examination procedures followed by the Federal Home Loan Bank Board were made available for study by the special committee.

SECTION 3

Outline of Audit

In consideration of the scope of the audit which is about to be made, due weight must be given to its purpose and also to the system of internal check in effect. The Federal Home Loan Bank Board examiners examine all associations whose accounts are insured by the Federal Savings and Loan Insurance Corporation and also members of the federal-home-loan-bank system located in states in which state supervision is regarded as inadequate. In most commonwealths, the state examiners scrutinize the records of each association incorporated therein in order to determine that the association is solvent and that it is operating in accordance with state laws and regulations. The certified public accountant is not relieved by either of these examinations from carrying out his regular program, although the reports rendered by supervisory authorities may be of value to him.

In associations where an adequate system of internal check and control is in operation, the detailed tasks of the auditor may properly be curtailed. It is the duty of the auditor to recommend the instalation of such a control if one can be operated without occasioning a great deal of added expense to the client. The extent of test checking necessary is a matter of judgment to be exercised in view of the conditions peculiar to each particular engagement.

TITLES, APPRAISALS

Technical details regarding appraisals, property valuation, and the status of titles are not in the province of the auditor. He should, however, satisfy himself that the considered opinion of qualified experts are on file regarding the value and ownership of the assets and the adequacy of the reserves. Whenever legal and engineering problems arise, it would be well for the accountant to make reasonable inquiry and upon ascertaining the facts, where appropriate, insist that the association procure for his satisfaction the opinion in regard thereto of its legal or engineering advisors.

FEDERAL AND STATE REQUIREMENTS

It is requisite for the accountant engaged in this kind of work to acquaint himself with federal or state requirements, such as, for example, the method of setting up reserves against properties or overdue mortgages, as established by certain states. He must also be well informed on the accepted accounting practice for such associations and should satisfy himself that these accepted accounting practices have been consistently followed throughout the period covered and are on a basis consistent with that of the preceding year.

BY-LAWS

A review of the association's by-laws should be made at the beginning of the examination.

STATEMENT OF CONDITION

If the statement of condition (hereinafter referred to as the balance-sheet) and the statement of operations and reconcilement of undivided-profits account and reserves have been prepared by a representative of the association, the accountant, in addition to verifying their accuracy, should make certain that they are in an accepted form. A form is set forth at the conclusion of this outline.

It is important to see that no items are offset, one against the other, which would establish a "net" condition in either assets or liabilities unless all assets and all liabilities are fully described. Outstanding changes in the association's condition are reflected by a comparison of the opening and closing statements for the period under audit. Such changes may require more than ordinary attention from the auditor.

MINUTES

The minutes of the directors' and the shareholders' meetings should be read, and any items appearing therein which affect the financial transactions of the association should be noted. The accountant should satisfy himself that these transactions have been handled in accordance with the minutes and with the law under which the association is operating.

Approval for the following should ordinarily be found in the minutes:

(a) Loans made, refinanced, transferred, converted, foreclosed, or partially released.
(b) Real estate acquired and disposed of.
(c) Contract sales made or extended.
(d) Funds borrowed.
(e) Maturity of shares if board action is required to mature shares.
(f) Dividends declared and profits apportioned.
(g) Additions to and deductions from the contingent reserve, undivided profits, and other reserve accounts.
(h) Fixing rates of interest, premiums on loans, and loan plans.
(i) Fixing salaries of officers, directors, and important employees.
(j) Approving surety company bonds.
(k) Approving depository bank and designating signatories on checks.
(l) Purchase and sale of securities during the period under review should be authorized by the board of directors.

The minutes of shareholders' and directors' meetings should be appropriately signed and witnessed.

CASH AND NEGOTIABLE SECURITIES

Cash and negotiable securities should be counted or confirmed concurrently as of the same date, preferably as of the close of business on the date of the statement of condition. If, for any reason, this work cannot be done until a later date, the count or confirmation should be made as of that date, and the changes in the intervening period should be checked in detail. The extent of this scrutiny will be governed by the special conditions of each case.

VERIFICATION OF RECEIVABLES

The best verification of balances of receivables (accounts, notes, mortgages, etc.) and members' deposit or share accounts, etc., can be obtained by the accountant's requesting confirmation direct from the debtors or members. Wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of an association, confirmation of receivables by direct communication with the debtors should be regarded as generally accepted auditing procedure; and the method, extent, and time of obtaining such confirmations in each engagement, whether of all receivables or a part thereof, should be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment. The Federal Home Loan Bank Board requires a minimum circularization of at least ten per cent of the number and amount of each class of accounts. The requirements of the state law under which the association is organized must be ascertained by the accountant. Objections to such circularization no longer carry much weight, as the public is now fairly well acquainted with its purpose. As a matter of fact, a careful wording of the request conveying that it is in keeping with up-to-date practice and for the greater protection of the members is an excellent advertisement for the association.

The confirmation statements used are generally of the affirmative type requiring direct replies to the auditors. In order to facilitate the audit, arrangements may be made to have these statements prepared by the staff of the association, after which they are checked back and mailed by the auditors. The statements should show the status of shareholders' accounts with respect to dues paid, profits apportioned, mortgage loans, share loans, arrears, and advance payments. When sufficient replies are not received, second requests are generally forwarded.

There follow suggestions as to routine work to be done with respect to various accounts, grouped in the order in which the accounts appear in the attached statement of condition. Cash and securities are considered first, since they usually are the first items taken up in the audit.

In the following discussions as to the scope of audit of the various assets and liabilities, reference, as a rule, has been made to supporting schedules only in instances where it was thought desirable to stress the information to be revealed. It should be understood that the underlying details in all cases, with the possible exceptions of accruals, should be in agreement with the controlling accounts in the general ledger. If the lists have been prepared by the association for the use of the accountant, they should be checked with the underlying records and footed.

Procedure for the audit of income accounts is taken up under the statement of operations, rather than in the discussions of the relative assets. Similarly, accruals have been dealt with under a separate caption.

The subclassifications used hereinafter are those shown in the statement of condition and statement of operations recommended by the accounting division of the United States Savings and Loan League.

CASH

(1) Cash on hand should be counted, and the independent accountant should be satisfied that the association is using a good system of petty-cash control. Any negotiable securities should be inspected or taken under control at the time of the petty-cash count. The independent accountant should guard against the possibility that a cash shortage in such assets is concealed by a temporary conversion of securities.

(2) When counting cash it is important to observe that all checks produced as part of the cash balance have been entered in the cashbook prior to the close of the period. Any checks or advances made from cash but not recorded on the books should be noted. Scrutinize advances to employees and see that personal checks or checks cashed for others as an accommodation are deposited and paid before the completion of the examination.

(3) Bank balances as of the close of business on the balance-sheet date should be confirmed to the accountant by the depositaries, using the standard bank-confirmation form devised by the American Institute of Accountants. These balances should be reconciled with the balances shown on the cashbook and checkbook stubs or check registers, and particulars of all outstanding items should be noted. The checks returned by the banks should be compared with the cashbook disbursements. In the case of small associations, it may be considered advisable to do this for the entire year. In the case of associations having a good system of internal check, this comparison of checks should be made for two or three months chosen at random, except that the last month of the period under examination should be covered. Spoiled checks should be accounted for. The list

of outstanding checks at the close of the audit period should be compared with the checks returned by the banks in the subsequent month. Any unpaid checks which have been outstanding for a long interval should be especially investigated.

(4) Comparison of recorded cash receipts to bank deposits is required. For small associations, this should be done for the entire period. For associations having a good internal control, the same test may be made as indicated above for the examination of canceled checks.

(5) Footings of cashbook columns must be proved for at least the period during which checks are examined.

(6) All checks outstanding at the beginning of the period which were not returned in a previous audit must be compared to the cash-disbursement entry.

(7) If it is the practice of the association to delegate a person to make distribution of mortgage-settlement funds, this person's accounts should be examined so that it may be ascertained, first, that the association's checks have been deposited by the disbursing trustee and, second, that the trustee's disbursements are in order.

(8) All cash transfers between bank accounts of the association and between these and accounts maintained by trustees must be traced.

SECURITIES

Savings-and-loan associations frequently own stock in the Federal Home Loan Bank, Federal Home Loan Bank bonds, and United States Government securities, including those of the Home Owners' Loan Corporation. Occasionally there may be other securities on hand.

The procedure for the audit of these securities is as follows:

1. Obtain or prepare a list of securities owned showing particulars such as:

Description of security.
Serial number of bonds or other securities.
Denomination of bonds or par value of shares.
Interest rate of bonds.
Face value of bonds; number of shares.
Cost of securities and the amount at which carried on the books.
Interest and dividends received during period under review.
Interest accrued and dividends receivable at the close of the period under review.
Market quotations if such are available, location of securities and, if hypothecated, with whom and for what purpose.

2. Compare securities listed with the corresponding ledger accounts to ascertain the basis on which the securities are carried on the books. Wherever practicable, serial numbers of bonds and other securities should be compared with records of security purchases in order to obtain positive identification and avoid possibility of substitution.

3. Examine the securities listed, or obtain confirmation from the holders, if any are held by depositaries or others for safekeeping or as collateral. This examination should be made as close to the date of the balance-sheet as possible (see paragraph 1 under "Cash"). It is, of course, more desirable to inspect the actual securities than to account for their disposition subsequent to the date of the balance-sheet.

4. See that certificates of stock and registered bonds are made out in the names of the association or, if they are in the names of others, that they are so endorsed as to be transferable to the association or are accompanied by powers of attorney.

5. Examine coupons on bonds to ascertain that unmatured coupons are intact.

6. If certificates are out for transfer, confirm with transfer agents.

7. If securities have been bought or sold through brokers, examine brokers' advices in support of purchase sales prices on both.

8. Stocks and bonds should be shown separately on the statement of condition and should not be confused with mortgage loans and share loans.

9. If securities are stated at prices other than market, the quoted market values should also be shown on the balance-sheet. If the total market value of stocks and bonds which might represent temporary investments is less than the total book value by any material amount, and a reserve for the shrinkage has not been provided, the auditor should draw attention to the fact in his report.

10. If the association has hypothecated any of its securities, this fact should be stated on the statement of condition, or mention thereof made in the auditor's report.

MORTGAGE LOANS

Mortgage loans are classified in the statement of condition as follows:

A. First-mortgage loans:
   - (a) First-mortgage direct-reduction loans.
   - (b) First-mortgage share-account sinking-fund loans.
   - (c) First-mortgage straight loans.

(d) Accrued interest receivable on first-mortgage loans (unless included in balance of first-mortgage loans).
(e) Advances for taxes, insurance, etc., on first-mortgage loans (unless included in balance of first-mortgage loans).

B. Second-mortgage loans:
(a) Second-mortgage loans.
(b) Accrued interest receivable on second-mortgage loans.
(c) Advances for taxes, insurance, etc., on second-mortgage loans.

1. The following papers supporting mortage loans should be examined on the first examination of the association:

Mortgage.
Note or bond and warrant.
Title insurance policy, guaranteed search, or solicitor's search or abstract.
Property-insurance policy — fire, tornado, etc.
Loan application properly signed by mortgagor.
Loan approval signed by proper committee.
Appraisal reports.

Upon subsequent examinations, the accountant should use his discretion in making a complete check or test check of old loans; in any event, papers supporting all new loans should be examined. The accountant should satisfy himself that all notes or bonds and mortgages or trust deeds are on hand or accounted for.

In some cases, a separate assignment of shares signed by the mortgagor is necessary. If the minutes of the proper committee reports the requirement of additional collateral, the assignment of such collateral and the collateral itself should be examined by the auditor.

If the loan is secured by a second mortgage, the amount of the first lien should be listed and, if it is the practice of the association to acquire sheriff's or marshal's certificates, the auditor should see to it that the certificates are included among the second-mortgage papers.

The auditor should ascertain the mortgages of directors, officers, and employees, and those of firms or companies in which such officials are known to be interested, and make suitable mention in his report of the aggregate amount if deemed significant and all other loans which in his opinion require special mention.

2. It is preferable to confirm mortage loans outstanding and arrearages thereon directly with the mortgagors. If this cannot be done, a qualification to that effect should be included in the accountant's report.

3. The accountant should familiarize himself with the requirements of savings-and-loan-association mortgage loans, and should see that the required number of shares have been assigned to the association by the mortgagor in conformity with the agreement between mortgagor and association.

4. All loans granted and foreclosures commenced during the period under review should be compared with the authorization in the minutes.

5. The accountant should familiarize himself with state and federal provisions under which the audited association is operating in order to determine whether its loan policy is in compliance therewith.

6. The accountant should also inquire into unpaid taxes and assessments pertaining to mortgaged properties.

7. Loans pledged with the Federal Home Loan Bank or other lender should be confirmed by direct communication. A proper notation should be made on the balance-sheet by footnote or mention thereof made in the auditor's report concerning mortgages pledged as collateral on borrowed money.

8. Entries for partial or full repayments of mortgage loans during the period under review should be checked.

SHARE LOANS

Share loans are classified in the statement of condition as follows:

(a) Loans secured by shares of this association.

(b) Loans on deposit accounts and certificates of investment.

(c) Accrued interest receivable (unless included above).

Audit procedure is suggested as follows:

1. Papers supporting share loans should be examined.

2. It is preferable to confirm share loans outstanding directly with the borrowers, and if this cannot be done, a qualification to that effect should be included in the accountant's report. The authority for the creation of share loans should be found in the minutes if such authority is required by statute. The shareholder's note should be examined, as well as his pledged certificate or passbook.

3. The accountant should make certain that sufficient payments have been made to warrant the amount loaned; he should also ascertain if the amount borrowed by the shareholder is within the limitation permitted by law.

4. Credits appearing on the loan accounts of shareholders during the year under review should be checked or tested.

5. The accountant should draw off a list of those share loans which may require special consideration.

OTHER LOANS

These loans are classified in the statement of condition as follows:

(a) Loans on other security.
(b) Unsecured loans.
(c) Accrued interest receivable on above.

The same procedure as that set forth under the examination of share loans should be followed in the case of other loans, and written confirmations should be obtained.

REAL ESTATE SOLD ON CONTRACT

This is listed and classified in the statement of condition as follows:

(a) Real estate sold on contract.
(b) Accrued interest receivable on real estate sold on contract (unless included above).
(c) Advances for taxes, insurance, etc., on real estate sold on contract (unless included above).

1. These contracts should be examined and the accountant should draw off a list of the contracts which may require special consideration.

2. The accountant should also examine the underlying documents of title.

3. The remarks under mortgage loans as to the desirability of requesting confirmation from debtors also apply to real estate sold on contract.

REAL ESTATE SALES

If the property has been sold at a profit, there are three methods which may be used to take up such profit:

(a) The first cash funds received might be considered realized profit.
(b) The profits arising from the sale of real estate might be taken into earnings in the proportionate amount consistent with the cash paid by the purchaser.
(c) The profit might be deferred until the last payment is received from the purchaser.

The association should be consistent in its method of handling the profits on the sale of all parcels of real estate owned.

ACCRUED INTEREST RECEIVABLE

Included in the several classes of assets previously dealt with there is accrued interest receivable on:

(1-d) First-mortgage loans.
(2-b) Second-mortgage loans.

(3-c) Share loans.
(4-c) Other loans.
(5-b) Real estate sold on contract.
(10) Investments.

1. The accountant should note the method of computing interest and satisfy himself that the details are proved with the controlling accounts.

2. A reasonable test should be made as to the computations on individual cases.

3. It should be borne in mind that the only complete check on delinquents is in the obtaining of confirmations.

4. Interest accrued on mortgages in arrears or interest should be carried to a reserve account rather than credited to income. A practice required of all federal savings-and-loan associations is to reserve for accrued interest on mortgage loans where it is overdue for more than ninety days. It is recommended by the American Savings and Loan Institute that all interest be credited to a reserve until it is actually collected.

REAL ESTATE OWNED

This is classified in the statement of condition as follows:

Real estate owned (exclusive of office building).
Real estate equitably owned (in dummy holder).
Real estate in judgment and subject to redemption.

The second item is included merely to insure the fact that an association will not report, as mortgage loans, real estate which is actually owned but which, for some reason, is held in the name of some individual rather than the association.

The auditor should:

1. Scrutinize carefully the accounts covering all new acquisitions in the real estate account, checking the cost of each parcel with properly approved vouchers. Inquiry should be made as to the basis of establishing the book value of real estate acquired and the accountant's report should contain comment on the basis used.

2. Check the sales prices of all real estate disposed of during year with sales agreements and directors' authorizations.

3. Examine deed, certificate of counsel as to title, guaranteed search, or title-insurance policy, pertinent to each parcel of real estate owned.

4. Check property-insurance policies. Note whether the association is apparently protected against the most common hazards, which include fire, tornado, and owners' liability.

5. Check by direct communication accounts of rents in arrears

of each tenant; test check by direct communication rental accounts not in arrears; and prepare a schedule of rental arrearages.

FIXED ASSETS

1. An analysis of the accounts for such assets as the office building and the furniture and fixtures of the association should be prepared. Such an analysis should set forth:
   (a) Balance of account at beginning of period under review.
   (b) Cost of new acquisitions or additions.
   (c) Accumulated depreciation allowance at beginning.
   (d) Provision and charges to depreciation reserve for year under examination.
   (e) Encumbrances on each asset.
   (f) Insurance carried covering each asset.
   (g) Appraisal value, if any.
   (h) Assessed value of real estate.
   (i) Unpaid taxes and assessments.
   (j) Income from other tenants and operating costs of real estate used to house the association's offices.

2. Sales of fixed assets should be scrutinized, and profits or losses therefrom, when determined, should be recorded separately as extraordinary charges or credits.

3. Any additions or retirements of fixed assets should be supported by properly approved vouchers and (in the case of larger items) by directors' approval.

4. The auditor should also examine the documents of title to the office building.

MISCELLANEOUS ASSETS

Details should be obtained and checked in connection with all miscellaneous assets of any consequence. Pertinent data describing such items should be included in the comments of the accountant's report.

SHARE ACCOUNTS

The accounts of shareholders are classified in the statement of condition as follows:

A. Repurchasable or free shares.
   (a) Instalment shares dues credited.
       Deduct — Delinquent dues (if carried).
       Add — Dividends (unless included in dues credited above).
   (b) Optional shares (payments and dividends).

(c) Prepaid shares (or income shares).
Add — Dividends (unless included with shares).
(d) Full-paid shares.
(e) Matured shares.

B. Mortgage-pledged shares.
Deduct — Delinquent dues (if carried).
Add — Dividends.

1. If the association is operating on the serial plan, the above distinction between free and mortgage-pledged shares may not be readily available, because the value of shares is set forth according to series, and the statement which records the progress of shares toward maturity merely indicates the number of free and of pledged shares in each series but does not compute the value of each class. In the lists of arrearages and of advance payments which are frequently used in such cases, the delinquencies or advances on free shares are scheduled with those on pledged shares. While it has not been customary to segregate these items, it is nevertheless considered to be advisable to do so because it is more informative. Mortgage-pledged shares exist in an association which makes share-account sinking-fund loans.

2. In making an examination of share accounts, the following items should be taken into consideration:

(a) The general-ledger controls must be in agreement with the footings of the balances in the subsidiary ledgers.
(b) Confirmation of shareholders' accounts by direct communication is desirable. (See "Verification of Receivables," page 5.) Such confirmation should include the accounts repurchased, withdrawn, or matured during the period under review.
(c) Serial numbers of passbooks and of certificates issued and canceled should be accounted for and canceled certificates inspected.
(d) Test check the dividends paid or credited to shareholders during the period under review.
(e) Ascertain if the association's earnings are sufficient to cover the rate of dividend declared and that such dividends are in accordance with statute, by-law, and certificate provisions.

DEPOSITS, INVESTMENT CERTIFICATES

Where these exist the same procedure as that set forth under paragraph two of share accounts should be followed. The accountant should examine canceled certificates in support of withdrawals during the period and should inquire into the control exercised over the issuance of certificates.

ADVANCES FROM FEDERAL HOME LOAN BANK AND OTHER BORROWED MONEY

These should be scheduled and confirmed by direct communication. Interest accrued thereon should be checked.

All advances from the Federal Home Loan Bank and borrowed money must be authorized by the board of directors and should be treated in a manner which conforms to provisions of statutes, charter, and by-laws.

OTHER LIABILITIES

The following liabilities should be scheduled and checked to the satisfaction of the accountant:

1. Mortgages on real estate owned.
   - (a) Confirm this item and all pertinent facts with mortgagee.
   - (b) List pertinent information concerning the mortgage, including date made, date due, name of mortgagee, amount, and property covered.
   - (c) If such a mortgage is not permitted by the law under which the association is operating, the accountant should so advise the board of directors.
   - (d) Any mortgage against real estate owned which has been assumed or created by the association should be shown as a liability rather than be deducted from the asset account.
2. Dividends declared, unpaid, and uncredited.
   - (a) Check authority for such dividends.
   - (b) Unless for current period, determine why they have neither been paid nor credited.
3. Taxes accrued and unpaid on real estate owned.
   - (a) Obtain list of such items and compare with tax bills and the list of properties owned.
   - (b) If the accountant is not satisfied with the association's tax records, and where property was acquired without foreclosure, a tax search should be recommended.
4. Accounts payable.

   Ordinary obligations such as those incurred by any other business may result in accounts payable, particularly for expense bills rendered to the association.

   Obtain a list of the recorded accounts payable and make appropriate check with the ledger accounts. Reconcile the total with the controlling account in the general ledger.

It is suggested that the accountant review payments shown by the cashbook subsequent to the date of the balance-sheet to ascertain whether any of them is applicable to the period under review. Bills on file which have not been entered should be examined to determine whether any of them belongs to the period under review.

Investigate any large balances which do not represent specific or recent items. Obtain confirmation from the creditor if any account appears to be irregular.

5. Loans in process.

These include loans which have been approved by the board of directors but for which funds are either entirely or partially withheld. This account should be analyzed to detect dormant accounts and overdrafts. Such loans may be confirmed by direct communication with borrowers. A list of such loans should be prepared and retained by the accountant.

6. Advance payments.

These comprise the following:

(a) Advance payments by borrowers for taxes and insurance (if carried separately).

(b) Unapplied mortgage credits.

It is preferable to secure confirmations of advance payments directly from the borrowers when requesting confirmation of mortgage loans.

The accountant's report should set forth clearly the provisions of the association's mortgage contracts, that is, whether these credits are applied to the mortgages semiannually or at other stated periods.

7. Accrued interest payable.

Under this heading would be included accrued interest payable on such items as:

Deposits.

Money borrowed and mortgages payable:

(a) The accountant should review all liability accounts to ascertain whether interest has been accrued on all interest-bearing obligations.

(b) The accountant should check the method of computing interest and determine that the details prove with the controlling accounts.

(c) The charge therefor appearing in the statement of operations should at least be test checked against the liabilities outstanding throughout the year.

(d) Where the liabilities bearing interest are confirmed, the accrued interest should also be confirmed.

8. Federal or state taxes payable.

If the association is liable for any taxes, the accountant should check their computation.

PERMANENT, RESERVE OR GUARANTY STOCK

Wherever such stock exists, examine the stock records, the authorization for its issue by the board of directors, and the propriety of the stock under state law. Confirmation by direct communication with shareholders is desirable and at least 15 per cent of shareholders' accounts should be circularized. The Federal Home Loan Bank Board audit requires check and inspection of at least 10 per cent of the number of accounts and some states require more circularization than the 15 per cent suggested above. In the latter cases the accountant must comply with state requirements. Certificates should be accounted for by number and those canceled during the period should be examined.

DEFERRED CREDITS TO FUTURE OPERATIONS

This may include many different items, the most common of which will be (a) income collected in advance and (b) unrealized profit on real estate sold.

(1) A check should be made on the mathematical accuracy of the computation of income collected in advance, the extent thereof depending on the volume and on the system of internal check in use.

(2) The accountant should ascertain the association's policy as to taking into income the earned portion of deferred credits.

RESERVES

1. These are placed into two main groups with subordinate classes as follows:

(a) Specific reserves.
- (1) For uncollected interest.
- (2) For junior liens.

(b) General reserves.
- (1) Legal reserve.
- (2) Federal-insurance reserve (if insured).
- (3) Contingencies.
- (4) Real estate.

2. A schedule should be obtained or prepared summarizing the changes during the period as follows:

Title of reserve.

Balance at beginning of period.

Credits:

Through charges to profit or undivided profit.

Other credits.

Charges:

Through credits to profit and loss or undivided profits.

Other charges.

Balance at end of period.

3. While uncollected interest is included as an asset under first-mortgage loans, a conservative practice in the savings-and-loan business dictates that it should not be included as part of the association's undivided profits and it is common practice among associations to reserve for the entire amount of uncollected interest. A practice required of all federal savings-and-loan associations is to reserve for accrued interest on mortgage loans only in instances where it is overdue for more than ninety days. The accountant should ascertain that the reserve is set up on the basis authorized by the board, should form an opinion of its adequacy, and if necessary qualify his report.

4. It is common practice to create a reserve in full for all junior liens (such as second mortgages). If this is the desire of the association's board, the accountant should call attention to the existence of any errors or omissions. If, however, another method is used and the reserve is obviously too low and the amount is relatively important, the accountant should include a proper qualification in his report. The accountant, however, is not an appraiser and is therefore not in a position to assume responsibility for valuations of real estate and properties underlying mortgage loans.

5. Federal and state supervising authorities have legal requirements for creation of reserves. The accountant should ascertain if the association has properly computed such legal reserves.

6. If the association is insured, the accountant should ascertain if it has created the reserves required by Federal Savings and Loan Insurance Corporation.

7. Reserves for contingencies should be scrutinized not only to determine whether they appear to be sufficient, but also to ascertain whether they are excessive.

8. The accountant should make use of up-to-date reports of competent appraisers in checking the amount of real-estate reserves.

9. Expenditures charged to the reserves should be vouched, and it

should be ascertained that the minutes contain proper authorizations for assets charged off against reserves. The accountant should insist on the correction of items in the nature of operating expenses improperly charged against reserves, otherwise a qualification relative thereto is necessary in his report.

10. The auditor should satisfy himself as far as possible that all recoveries of bad debts or other items charged against reserves in prior years have been properly recorded.

BONUS ON SHARES AND RESERVE FOR ESTIMATED DIVIDEND REQUIREMENTS

1. The charter for federal savings-and-loan associations and some state statutes provide for a bonus on shares as a portion of profits which is available for those shareholders who establish a prompt-payment record. Any increase or decrease in such bonus should be carefully examined by the accountant and checked with the association's charter and by-laws, as well as statutory requirements, as applicable.

2. The reserve for estimated dividend requirements is merely the earmarking of an approximate portion of undivided profits which are to be made available to shareholders on the next dividend date upon authorization by the board of directors.

UNDIVIDED PROFITS

1. Analyze undivided profits for the period covered by the examination. Reconcile the opening balance with the undivided profits in the previous balance-sheet.

2. Dividends declared, paid, or credited should be checked with the minutes of the board of directors' meetings.

3. The accountant should consider the propriety of all entries in the undivided-profits account.

4. Check statutory regulations and limitations, if any, governing this account.

STATEMENT OF OPERATIONS

GENERAL

1. The accountant should satisfy himself that income and expense are properly classified in so far as the facts are known to him or are ascertainable by reasonable inquiry. The extent of the audit of profit-and-loss operations during the period under audit is dependent upon the factors discussed at the beginning of section 3.

2. This statement should show a breakdown of income and ex-

pense into subdivisions similar to those adopted by the accounting division of the United States Savings and Loan League.

3. Comparative statements are recommended, and it is suggested that the accountant look into those items which vary materially between the two periods.

INCOME

Much of the work on the items of income will in practice be carried out concurrently in connection with the examination of the corresponding asset accounts.

1. The main operating income of savings-and-loan associations consists of interest on mortgage loans and interest on share loans. These items should be checked by an examination of the loan accounts and a comprehensive test check of income for two or at least one selected month of the period under review, depending upon the size of the association.

2. Rents collected on properties owned may make up a large item of income. The record should be examined in connection with each particular property, checking back the monthly receipts of each tenant as indicated by the leases and the collector's duplicate receipt books or collector's monthly report. The monthly rent and the arrears of rent, if any, may be confirmed by direct correspondence with the tenant. At least a test circularization of all rental accounts should be made.

3. Other income consists of interest on investments, premiums on loans, appraisal fees, fines, membership fees, transfer fees, etc. The policy of each association with respect to these fees should be investigated and test checks made sufficient to satisfy the auditor whether such income has been properly accounted for. It should be noted that bond coupons have been deposited on or about the proper date.

4. Where amounts of premiums on loans are substantial, they may be taken into income over a period of years and current income therefrom will have been checked in connection with the work on deferred credits.

5. The nonoperating income consists of dividends or apportioned profits retained on withdrawals, profit on sale of real estate, and profit on sale of investments. These, of course, should be checked in an appropriate manner.

EXPENSES

Much of the work on the items of expense in practice would be carried out concurrently with the audit of the corresponding liability accounts.

1. The expenses consist in part of the cost of operating the real es-

tate. Disbursements should be supported by bank vouchers or other appropriate vouchers, and these should be test checked to invoices rendered to the association. Each invoice should bear the approval of the manager of the real estate or of the members of the special real-estate committee, depending upon the practice of the association, which is sometimes governed by statutory or supervisory regulation.

2. Other important expenses are compensation to directors, officers, and employees. These should be vouched or checked to see that proper authorization has been given by the board for the amounts paid. If the association owns its building, there would of course be disbursements for its maintenance.

SECTION 4

Statements

The statement of condition, the statement of operations, reconcilement of undivided profits, and the statement of reserves are set forth below in the form which has been found to be acceptable to the examining division of the Federal Home Loan Bank Board. The statements are rendered in sufficient detail to give all required information to the management and to the shareholders of the association under review. In any event, the basis on which real estate, investments, office building, and furniture and fixtures are stated in the balance-sheet should be indicated. More condensed statements would ordinarily be prepared for dissemination to the general public.

Name of institution ....
As of close of business on ...., 19....

Assets

1. First-mortgage loans:		
a. First-mortgage direct-reduction loans	$	
b. First-mortgage share-account sinking-fund loans		
c. First-mortgage straight loans		
d. Accrued interest receivable on first-mortgage loans (unless included above)		
e. Advances for taxes, insurance, etc., on first-mortgage loans (unless included in above)		$
2. Second-mortgage loans:		
a. Second-mortgage loans	$	
b. Accrued interest receivable on second-mortgage loans		
c. Advances for taxes, insurance, etc., on second-mortgage loans		$
3. Share loans:		
a. Loans secured by shares of this association	$	
b. Loans on deposit accounts and certificates of investment		
c. Accrued interest receivable on items 3-a and 3-b (unless included in 3-a and 3-b)		$
4. Other loans:		
a. Loans on all other security	$	
b. Unsecured loans		
c. Accrued interest receivable on items 4-a and 4-b		$
5. Real estate sold on contract:		
a. Real estate sold on contract	$	
b. Accrued interest receivable on real estate sold on contract (unless included in 5-a)		
c. Advances for taxes, insurance, etc., on real estate sold on contract (unless included in 5-a)		$
6. Real estate owned (exclusive of office bldg.)		
7. Real estate equitably owned (in dummy holder) ...		
8. Real estate in judgment and subject to redemption		
9. Investments:		
a. Stock in Federal Home Loan Bank	$	
b. Federal Home Loan Bank bonds		
c. U. S. Government obligations (including H.O.L.C.)		
d. Other investment securities		
10. Accrued interest receivable on investments		
11. Cash on hand and in banks		
12. Office building (if owned):		
a. Office building	$	
b. Less allowance for depreciation		
13. Furniture, etc.:		
a. Furniture, fixtures, and equipment	$	
b. Less allowance for depreciation		
14. Deferred charges		
15. Other assets		
Total assets		$

Capital and Liabilities

20. Repurchasable or free shares:		
a. Instalment share dues credited	$	
Deduct—Delinquent dues (if carried)		
Subtotal		
Add—Dividends (unless included in 20-a)		
Net free instalment shares		$
b. Optional shares (payments and dividends)		
c. Prepaid shares	$	
Add—Dividends (unless included in 20-c)		
Net prepaid shares		
d. Full-paid shares		
e. Matured shares		
f.		
g.		
Total repurchasable or free shares		$
21. Mortgage-pledged shares	$	
Deduct—Delinquent dues (if carried)		
Subtotal	$	
Add—Dividends		
Net mortgage-pledged shares		
22. Deposits, investment certificates (by classes):		
a.	$	
b.		
c.		
d.		
23. Interest accrued on item 22		
24. Advances from Federal Home Loan Bank		
25. Borrowed money:		
a. From banks and other associations	$	
b. From others		
26. Mortgages on real estate owned		
27. Interest accrued on items 24, 25, and 26		
28. Dividends declared, unpaid, and uncredited		
29. Taxes accrued and unpaid on real estate owned		
30. Accounts payable		
31. Loans in process		
32. Advance payments:		
a. Advance payments by borrowers for taxes and insurance (if carried separately)	$	
b. Unapplied mortgage credits		
33. Other liabilities		
34. Permanent, reserve, or guaranty stock		
35. Deferred credits to future operations:		
a. For unearned profit on real estate sold		
b. For income collected in advance		
c.		
36. Specific reserves:		
a. For uncollected interest	$	
b. For junior liens		
c.		
37. General reserves:		
a. Legal reserve	$	
b. Federal-insurance reserve (if insured)		
c. For contingencies		
d. Real estate reserve		
e.		
38. Bonus on shares		
39. Undivided profits		
40. Reserve for estimated dividend requirements		
Total capital and liabilities		$

Exhibit B

STATEMENT OF OPERATIONS

Name of institution ....

	For the year From ...., 19...., to ...., 19....			Previous year ended ...., 19....		
I. GROSS OPERATING INCOME:						
1. Interest:						
a. On mortgage loans—ordinary cash collections	$______			$______		
b. On mortgage loans—all other	______			______		
c. On loans on shares, passbooks and certificates	______			______		
d. On real estate sold on contract	______			______		
e. On investments and bank deposits	______			______		
f. Other	______	$______		______	$______	
2. Premium or commission on loans (current instalment and amortizations only)		______			______	
3. Appraisal fees, legal fees, and initial service charges		______			______	
4. Other fees and fines		______			______	
5. Real estate operations:						
a. Gross income from operation of real estate owned	$______			$______		
b. Less—Cost of repairs, taxes, and maintenance	______			______		
Net income or loss from R.E.O. (black or red)		______			______	
6. Gross income from office building		______			______	
7. Dividends:						
a. On stock in Federal Home Loan Bank	$______			$______		
b. Other dividends	______	______		______	______	
8. Miscellaneous operating income		______			______	
9. Gross operating income			$______			$______
II. LESS OPERATING EXPENSE:						
10. Salaries, etc.:						
a. Compensation to directors, officers, employees, etc.	$______			$______		
b. Collection expense (agents, etc.)	______	$______		______	$______	
11. Legal services—retainer, traveling expenses, and special services		______			______	
12. Expense accounts of directors, officers, and employees		______			______	
13. Rent, light, heat, etc.		______			______	

14. Office building expense (if owned):				
a. Repairs, taxes, and maintenance of office building	$		$	
b. Depreciation of office building				
15. Furniture, fixtures, and equipment, including depreciation				
16. Advertising				
17. Stationery, printing, and office supplies				
18. Telegraph, telephone, postage, and express				
19. Insurance and bond premiums				
20. Federal insurance premium (if insured)				
21. Audit				
22. Supervising examinations and assessments				
23. Organization dues				
24. Other operating expense				
25. Total operating expense				
III. Net operating income before interest and other charges		$		$
IV. LESS INTEREST CHARGES:				
26. On deposits, investments, certificates, etc. ______%	$		$	
27. On advances from Federal Home Loan Bank				
28. On borrowed money				
29. Total interest				
V. Net operating income		$		$
VI. ADD NONOPERATING INCOME:				
30. Dividends retained on repurchases and withdrawals	$		$	
31. Profit on sale of real estate				
32. Profit on sale of investments				
33. Other nonoperating income				
34. Total nonoperating income				
VII. Net income after interest and before charges		$		$
VIII. LESS NONOPERATING CHARGES (do not use lines herein for items charged direct to reserves):				
35. Foreclosure costs and back taxes on real estate acquired (unless capitalized or charged to reserves)	$		$	
36. Loss on sale of real estate				
37. Loss on sale of investments				
38. Other nonoperating charges				
39. Total nonoperating charges				
IX. Net income for period		$		$

Exhibit C

Statement of Reserves

	For the year From ...., 19.... To ...., 19....		Previous year ended ...., 19....	
LEGAL RESERVE				
1. Balance at beginning of period		$		$
2. Additions during period:				
(a) From net profit	$		$	
(b)				
(c)				
(d)				
3. Total additions				
4. Totals of items 1 and 2		$		$
5. Deductions during period:				
(a)				
(b)				
(c)				
(d)				
(e)				
(f)				
(g)				
6. Total deductions				
7. Balance at end of period		$		$
FEDERAL INSURANCE RESERVE				
1. Balance at beginning of period		$		$
2. Additions during period				
3. Totals of items 1 and 2		$		$
4. Deductions during period:				
(a)	$		$	
(b)				
(c)				
5. Total deductions				
6. Balance at end of period		$		$
RESERVE FOR CONTINGENCIES				
1. Balance at beginning of period		$		$
2. Additions during period:				
(a) From net profit	$		$	
(b)				
(c)				
(d)				
3. Total additions				
4. Totals of items 1 and 2		$		$

5. Deductions during period:				
(a)	$		$	
(b)				
(c)				
(d)				
(e)				
(f)				
(g)				
6. Total deductions				
7. Balance at end of period		$		$

REAL ESTATE RESERVE

1. Balance at beginning of period		$		$
2. Additions during period				
3. Totals of items 1 and 2		$		$
4. Deductions during period:				
(a)	$		$	
(b)				
(c)				
(d)				
5. Total deductions				
6. Balance at end of period		$		$

OTHER RESERVES

1. Balance at beginning of period		$		$
2. Additions during period:				
(a)	$		$	
(b)				
(c)				
3. Total additions		$		$
4. Total of items 1 and 2		$		$
5. Deductions during period:				
(a)	$		$	
(b)				
(c)				
(d)				
6. Total deductions				
7. Balance at end of period		$		$

For the year ended ...., 19....

1. Balance of undivided profits at beginning of year..			$______
2. Net income for the year (item IX of exhibit B)....		$______	
Less distribution of net profit:			
3. Transfers to reserves..........................			
a. For bonus on shares...........	$______		
b. Legal reserve.................	______		
c. Federal insurance reserve (if insured)......................	______		
d. For contingencies.............	______		
e. Real estate reserve............	______		
f.	______		
Total transfers to reserves.....	______		
4. To dividends....................	______	______	
5. Balance to undivided profits (black or red).......			______
6. Balance before adjustments.....................			______
7. Other additions (itemize)......................			
a.		______	
b.		______	
c.		______	______
8. Subtotal......................................			______
9. Other deductions (itemize).....................			
a.		______	
b.		______	
c.		______	______
10. Balance of undivided profits at end of year (Item 39 of exhibit A)...............................			$======

SECTION 5

Auditor's Report

The auditor's report on the examination of a savings-and-loan association should be along the lines of those recommended in the American Institute of Accountants bulletin, *Examination of Financial Statements*. It should be concise and fully explanatory. Explanations and exceptions, if any, should be stated clearly and concisely, and distinction should be made between comments which are intended to be merely informative and those which indicate dissent from the particular practices of the association.

The accountant should be cautious in making any statements which are not literally true or which might arouse unwarranted implications. A suggested form of accountant's report follows:

SHORT FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT

To the board of directors of the XYZ Savings
and Loan Association:

We have examined the statement of condition of the XYZ Savings and Loan Association as of April 30, 1940, and the statements of operations, undivided profits, and reserves for the . . . . . period then ended, have reviewed the system of internal control and the accounting procedures of the association and, without making a detailed audit of the transactions, have examined or tested accounting records of the association and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying statement of condition and related statements of operations, undivided profits, and reserves present fairly the position of the XYZ Savings and Loan Association at April 30, 1940, and the results of its operations for the . . . . . period, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

NOTES

1. This report would be appropriate only if the accounting for the year is consistent in basis with that for the preceding year; if there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.

2. The form of report must, of course, be modified when necessary to include any qualifications, reservations, or supplementary explanations.

3. This form presupposes that the accountant will be satisfied

that his examination has been adequate and in conformity with the principles outlined in this bulletin.

4. The accountant's report should be addressed to the directors of the association or to its shareholders if the appointment is made by them.

DETAILED REPORT

In order that the auditor's report shall be sufficiently informative to satisfy the supervisory authorities, it is important that in addition to the certified statements the accountant submit a detailed report disclosing the scope of his work and a discussion of pertinent matters affecting the association's accounts. It should disclose all fiscal policies in use by the association under review.

The following suggestions are submitted as a guide to those matters which might well be covered:

(a) List of investments, showing market, income, and comments on items for which no income was received.

(b) As regards mortgages, list those:

Substantially past due as to payments or taxes.

Items in process of foreclosure.

Delinquent loans or new loans which exceed the percentage of appraisal permitted under the association's policy or statutes.

Accounting practice re: interest in arrears.

Comments on larger items in arrears and as to sufficiency of the reserve therefor.

List of mortgages out for filing and other items not examined such as insurance policies, appraisals, certificates of title, etc.

Insurance policies without mortgagee clause.

(c) Statistics relative to circularization such as:

(1) Number and amount of balances for which confirmations were received and the percentage thereof of the totals.

(2) Similar information as to:

Replies received where exceptions were not noted.

Replies received with exceptions and nature of exceptions indicated.

(d) A summary of changes of other real estate during the period.

(e) Comparative statement of income and pertinent percentages in relation thereto.

(f) Statement of application of funds.

(g) Insurance on office building, fidelity, burglary, and other insurance in effect.

(h) Instances observed where laws and regulations are not being observed.

(i) Statements along the lines of those required by the Federal Home Loan Bank Board or the recommendation of state supervisors.

Among other things, the accountant should disclose the practice of the association in evaluating property charges taken into the real estate account when a real estate contract is forfeited. When accrued interest is added to the balance of the contract, the report should disclose whether the amount of the accrued interest has been set up in the reserve for uncollected interest or is included as income.

The accountant's comments should state the practice of the association in setting up the account for real estate owned, that is, whether it has been included at the cost or appraised value, whichever is lower, or whether a reserve has been created for the amount by which costs of individual properties exceed the appraised value.

If the reserve for uncollected interest is credited when accrued interest receivable is set up on mortgage loans and such interest taken into income only when cash is received, the accountant's report should disclose this fact.

Generally, there is no provision for depreciation on real estate acquired by an association except on its office building. The reasoning behind this is that real estate is part of the investment account in the case of a savings-and-loan association and is not considered as fixed capital. If the association does depreciate real estate which has been acquired through foreclosure in the course of its regular lending operations, the accountant should disclose the practice.